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PASS FED BOARD OF GOVERNORS FOR RANDALL KROSZNER, PATRICE
ROBITAILLE
PASS EXIM BANK FOR MICHELE WILKINS
PASS OPIC FOR JOHN SIMON, GEORGE SCHULTZ, RUTH ANN NICASTRI
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TAGS: EFIN ECON EINV AR
SUBJECT: ARGENTINA ECONOMIC AND FINANCIAL REVIEW, SEPTEMBER
17 - OCTOBER 5, 2007

¶1. (U) Provided below is Embassy Buenos Aires' Economic and Financial Review covering the period September 17 - October 5, 2007. The unclassified email version of this report includes tables and charts tracking Argentine economic developments. Contact Econoff Chris Landberg at landbergca@state.gov to be included on the email distribution list. This document is sensitive but unclassified. It should not be disseminated outside of USG channels or in any public forum without the written concurrence of the originator. It should not be posted on the internet.

Highlights

¶1. Government alleges bank collusion in setting high rates
¶2. Argentine corporations tapping markets again, but face much higher financing costs
¶3. GoA also reportedly considering bond issue, but faces low demand and higher yields
¶4. Central Bank bans foreign purchases of new debt issuances
¶5. S and P upholds Argentina's rating, but calls for tighter fiscal and monetary policy
¶6. GoA submits 2008 Budget Bill to Congress in the face of opposition criticism
¶7. Argentina loses ground on Transparency International "Corruption" and World Bank "Doing Business" indices
¶8. September CPI increases 0.8% m-o-m, below estimates of "real" inflation; INDEC announces plan to introduce new CPI methodology in November
¶9. Another INDEC scandal: underreporting of Mendoza Province inflation figures

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Finance

Government alleges bank collusion in setting high rates
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¶2. (SBU) In response to the disproportionate impact of global financial volatility on the price of Argentine assets, and the resulting spike in local interest rates, the GoA accused local and foreign banks of colluding in the setting of high lending rates. Beginning late September, the Economy

Ministry's Internal Trade Secretary Guillermo Moreno (also known locally as the price control czar) and the national anti-trust commission (Commission Nacional de Defensa de la Competencia) demanded detailed information on trading activities from major financial sector entities, with the ostensible purpose of discovering evidence of collusion in setting rates.

¶3. (SBU) The Committee sent comprehensive surveys to the six foreign banks operating in Argentina (Citi, JPMorgan, Deutschebank, HSBC, BBVA, Santander) on all their trading activities dating back to 2002, and then selectively called in banks to grill them on their submissions. The Committee also sent similar questionnaires to local pension funds and banks, apparently with the added request for identities of the local institutions' private consultants.

¶4. (SBU) The local and international banks raised rates starting in July in direct response to international market volatility and the global flight to quality. Argentine assets were considered especially risky (due to manipulation of official statistics, high inflation, falling fiscal and trade surpluses, and GoA intervention in the economy), so international investment and hedge funds immediately began selling Argentine bonds. This is the reason why the worldwide re-pricing of risk had a disproportionate impact on Argentina. The rush to sell GoA and Central Bank bonds caused a severe liquidity crunch in the local financial system, steeply driving up local interest rates, including the interbank rate, and forcing local retail banks to compensate by dramatically raising rates across the board. The fact that inflation is high and increasing is also a factor, but more for medium to long term debt instruments. Local financial analysts contend that Guillermo Moreno's attack on the banks is just a continuation of the fiction

perpetrated by GoA leadership that the government's policies are not the source of deteriorating economic indicators (inflation, sentiment, lack of credit, falling investment).

Argentine corporations tapping markets again, but face much higher financing costs
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¶5. (SBU) Global financial markets appear to be reopening again for Argentine borrowers, following two months of uncertainty and international market turmoil that began in mid-July. On October 1, Edenor, one of Argentina's largest power distribution companies, priced a ten-year bond at a yield of 10.5% for $220 million, becoming the first Argentine corporate to tap the markets since end-July. Joint managers of the issuance, Deutsche and Citi, raised the offer from $200 million in response to higher than expected demand. However, the final yield was about 125 basis points higher than the pricing expected when the deal was originally announced in July (subsequently suspended due to poor market conditions), and at least 175 bps higher than the pricing of similar private debt issuances in the spring. Other Argentine private companies are planning or considering issuances, including IMPSA (Industrias Metalurgicas Pescarmona), which has scheduled a seven-year $250 million bond placement this week.

GoA also reportedly considering bond issue, but faces low demand and higher yields
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¶6. (SBU) Local daily Cronista Comercial reported October 2 that the GoA is also considering an issuance, possibly prior to the October 20-22 IMF/WB annual meetings. The Cronista article states that the GoA would issue a $500 million bond (no details of currency, maturity or pricing), despite expectations of much higher yields than for previous GoA issuances (given that Argentine bond prices have not recovered from the crisis). An Embassy banking sector contact asserted that there is no market appetite for a GoA issue at the moment, and speculated that the Cronista report

may have originated with an investor holding a short-position in Bonar X (a ten-year, dollar-denominated bullet bond with a 7% coupon issued under Argentine law, and maturing 2017). This banker suspects that the investor is looking to cover the short position, and is therefore sounding out the GoA to reopen the bond -- which would make it similar to a private issuance. The GoA last issued the Bonar X in mid-May at a yield of 8.44%, compared to current trading levels of 10.05%.

¶7. (SBU) The same banker also noted the increasing cost to the GoA associated with its inability to issue internationally, for fear of attachment by holdout bondholders. The banker estimated that recent global market turmoil, which had a disproportionate impact on Argentina, had increased the premium that the GoA must pay for only being able to issue debt under domestic law to about 100 basis points (or 1%). For the sake of comparison, GoA officials have argued to Emboffs in recent years that the difference between issuing domestically or internationally is only about 30-40 basis points. Given Argentina's estimated financing needs for 2008 of $5-7 billion, a 100 bps premium costs Argentina in the range of $50-70 million.

Central Bank (BCRA) bans foreign purchases of new debt issuances
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¶8. (SBU) Starting with the BCRA's October 2 debt auction, the BCRA implemented a change to its internal rules, banning foreign entities from buying BCRA debt instruments (mainly LEBACs and NOBACs, or letters and notes of the Central Bank). Only local entities (including locally registered foreign firms, including the six foreign banks operating here) are now allowed to participate in the auctions. The BCRA took this action to block out foreign hedge funds (or "hot money"). Hedge funds can still purchase BCRA debt on the secondary market, and the BCRA has over $20 billion in short-term debt (avg maturity of about 2 years) outstanding.

S and P upholds Argentina's rating but calls for tighter

fiscal and monetary policy
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¶9. (SBU) On September 25, Standard and Poor's Ratings Agency confirmed its Argentine rating at B for long term and B for short-term sovereign debt, with a stable outlook. However, S and P warned that the ratings could go either way in the future, depending on the next administration's ability to stabilize inflation and tighten both fiscal and monetary conditions. According to S and P, Argentina's failure to act in a timely manner to contain fiscal expenditures could result in lower growth and higher inflation. S and P also expressed concerns about institutional and policy risks, specifically the allegations of government interference in the GoA statistical agency, INDEC. S and P stated that this alleged manipulation has "weakened the credibility of the official inflation numbers," with official 2007 inflation estimates below 10% while private analysts are forecasting 15-18% or higher.

Economic Outlook

GoA presents 2008 Budget Bill to Congress in the face of opposition criticism
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¶10. (SBU) Economy Minister Miguel Peirano presented the highlights of the draft 2008 Budget to the Budget and Treasury Committee of the Chamber of Deputies on September
¶19. His refusal to entertain questions following his two-hour presentation angered opposition Deputies and led to opposition denunciations in the local press. As with previous years' budgets, the main assumptions of the 2008 budget are conservative compared to the Central Bank's survey

of private sector forecasts. This is the root of most opposition criticism, because the conservative assumptions for growth and inflation will result in an underestimation of revenues of over $3 billion, by some estimates. Since Argentina's so-called "super powers" Act gives the Executive authority to reprogram expenditures without subsequent Congressional approval, the President has great discretionary power over the use of excess revenues. The Chamber of Deputies is expected to debate the bill after the October 28 presidential elections.

Argentina loses ground on Transparency International and World Bank indices
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¶11. (U) For the second year in a row, Argentina fell in the rankings of both Transparency International's "Corruption Perceptions Index 2007" (CPI) and the World Bank's "Doing Business" report, each released September 25. In Transparency International's 2007 CPI ranking, Argentina ranked 105 out of 180 countries (compared to 93 out of 163 countries in 2006) in terms of perceived levels of corruption, with a 2.9 ranking on a scale of 0 - 10 (with 0 highly corrupt and 10 highly clean). Transparency International notes that a score below three indicates that "corruption is perceived as rampant." This rating places it alongside Mongolia, Albania, Bolivia, and Burkina Faso. In the Americas, Argentina ranked 23rd out of 32 countries. Among Latin American nations, Chile (#22 in the global ranking) and Uruguay (#25) again led the region in 2007, with Venezuela and Haiti lowest ranked in the hemisphere. Argentina also fell in the rankings of the World Bank's "Doing Business" report. In the Bank's 2008 composite survey on the "ease of doing business," Argentina ranked 109 out of 178 nations and territories surveyed, alongside Bangladesh, Nigeria, Belarus, and Nepal. It ranked 22nd out of 31 countries in Latin America and the Caribbean. For comparison, Argentina ranked 101 out of 175 in the 2007 report, and 93 out of 155 in the 2006 report.

Inflation

September CPI increases 0.8% m-o-m, below estimates of "real" inflation; INDEC announces plan to introduce new CPI

methodology in November
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¶12. (SBU) On October 4, the GoA statistical agency INDEC announced that the September CPI increased 0.8% m-o-m, in line with market expectations of what INDEC would report, but about half of the level of most economists' estimates for "true" inflation. According to INDEC, accumulated inflation for the first nine months of the year reached 5.8%, compared to the 10-12% rate that most private consultants estimate. All nine sub-indexes show increases, with the largest m-o-m increases being: equipment and home maintenance (1.8%), other good and services (1.1%) and housing (0.9%). Food and beverages, the key sub-index to calculate the basic food basket, increased 0.7%. Food and beverage prices are key data used to measure indigence and poverty levels. The chief economist of one of Argentina's largest unions calculates that the poverty level would increase by nine percentage points if the basic food basket were properly measured. Meanwhile, Julio Cobos, the Governor of Mendoza Province and also vice-presidential candidate and running mate of presidential front-runner Cristina Kirchner, stated October 4 that INDEC will introduce a new CPI methodology next November, based on a U.S. model.

Another INDEC scandal: underreporting of Mendoza Province inflation figures
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¶13. (SBU) The GoA Statistical Bureau INDEC announced September 24 that the National CPI increased 0.8% m-o-m in

August. The National CPI is a weighted average of seven provinces, including Buenos Aires (Province and City), Mendoza, San Luis, Cordoba, Santa Fe, Tucuman and Catamarca. The Director of Mendoza Province's Statistical Agency subsequently notified INDEC in writing (with the formal endorsement of the province's government) that INDEC had incorrectly reported Mendoza's August CPI. INDEC included a 1.5% m-o-m increase for Mendoza, whereas Mendoza had originally reported monthly inflation of 3.1%. This error created a scandal when it was reported in local papers, with local commentators adding it to the list of ways with which the GoA has manipulated the CPI since February 2007.

¶14. (SBU) Local analysts say that the overall objective has always been to report a low headline inflation figure, and the alleged means of achieving this include: underreporting items, deleting data, firing professional INDEC staff that refused to go along with the manipulation, and strong-arming the main grocery chains into holding store-wide sales on the days that INDEC staff do pricing surveys. The GoA has repeatedly denied such allegations, which are also the subject of a judicial investigation. Most of these efforts (as well as most price controls and subsidies) are focused on the greater Buenos Aires area, which makes up roughly 35% of Argentine GDP and population. As reported in the Economic Report sent September 9, inflation in the provinces is significantly higher than in Buenos Aires. And many economists cite as evidence of GoA statistics manipulation the fact that Buenos Aires city CPI increased 0.4% m-o-m in August, only half the National CPI. The Buenos Aires city CPI is generally used as the inflation benchmark for the whole country, and is also used to build the inflation-linked index that is used to adjust the GoA's peso-denominated debt.
WAYNE